

## CHAPTER 4

### SIMPLIFICATION

Simplification is advanced by a number of the Treasury Department proposals discussed in other chapters. This chapter is devoted to proposals particularly aimed at simplifying the tax system for individuals. The greatest simplification for individuals could come from a fundamental change in the procedures for collecting tax liabilities -- the elimination of the income tax return for many taxpayers. The Internal Revenue Service will consider implementing a return-free system for taxpayers who today file uncomplicated returns.

The proposals also would repeal the minimum tax for individuals, the political contribution credit and the presidential campaign check-off, and the adoption expense deduction. A floor would be imposed on employee business expenses and miscellaneous itemized deductions.

## STUDY RETURN-FREE SYSTEM

### General Explanation

#### Chapter 4.01

#### Current Law

Individuals whose income exceeds specified levels are required to file income tax returns each year.

#### Reasons for Change

The requirement to file income tax returns imposes a paperwork burden on taxpayers. This burden should be reduced to the extent consistent with sound tax administration.

#### Proposal

The Internal Revenue Service is considering the implementation of a return-free tax system. Individual taxpayers who meet requirements to be specified by the Internal Revenue Service would not be required to file income tax returns. Under a return-free system, the Internal Revenue Service would, at the election of each eligible taxpayer, compute the taxpayer's liability, based on withholding and information reports provided to the Internal Revenue Service currently. The taxpayer would be sent a report, which would set forth the taxpayer's tax liability, and the taxpayer would be free to challenge the Internal Revenue Service's calculation of tax.

#### Analysis

Institution of the return-free system, together with the increases in zero bracket amounts and the personal exemptions, would substantially reduce the number of returns that taxpayers need to file with the Internal Revenue Service each year. This, in turn, would eliminate burdensome recordkeeping required of taxpayers and costs incurred by them in preparing returns. The return-free system would initially be limited to single wage earners with uncomplicated financial transactions, roughly the 15 million taxpayers now filing the simplified Form 1040EZ. After a pilot program, the system could be extended to other individual taxpayers, and by 1990, roughly 66 percent of all taxpayers could be covered by the return-free system. It is estimated that at this level of participation the return-free system would save taxpayers annually approximately 97 million hours and \$1.9 billion in fees paid to professional tax preparers.

## REPEAL ALTERNATIVE MINIMUM TAX

### General Explanation

#### Chapter 4.02

##### Current Law

Taxpayers whose taxable incomes are substantially reduced by specified "items of tax preference" are subject to "minimum taxes" which may increase their overall tax liabilities. Noncorporate taxpayers with substantial tax preferences are subject to the "alternative minimum tax."

Noncorporate taxpayers whose regular tax liabilities are substantially reduced by tax preferences are, in effect, subject to the alternative minimum tax (AMT) in lieu of the regular income tax. The AMT is equal to 20 percent of the excess of the taxpayer's "alternative minimum taxable income" (AMTI) over an exemption amount.\*/ A taxpayer's AMTI is computed by (a) adding tax preferences back to adjusted gross income, (b) subtracting the "alternative tax itemized deductions," and (c) making adjustments for net operating loss carryovers and certain trust distributions included in income under the so-called "throwback rules." The alternative tax itemized deductions include (a) casualty losses, (b) charitable contributions, (c) a portion of deductible medical expenses, (d) certain interest expenses (including interest on debt incurred to acquire the taxpayer's principal residence), and (e) estate taxes attributable to income in respect of a decedent. The exemption amount for the AMT is (a) \$40,000 for a joint return or a surviving spouse, (b) \$30,000 for a single taxpayer, and (c) \$20,000 for other noncorporate taxpayers.

Items of tax preference generally include:

- (a) interest and dividends excluded from gross income;
- (b) the excess of accelerated over straight-line depreciation for real property and leased personal property (other than recovery property);
- (c) in the case of recovery property other than leased 18-year real property, the excess of ACRS deductions over depreciation

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\*/ The statutory term "alternative minimum tax" actually refers to the excess of (1) 20% of AMTI less the exemption amount over (2) the regular income tax. This excess is imposed in addition to the regular tax. For convenience, however, the terms "alternative minimum tax" and "AMT," as used herein, will refer to the sum of the true alternative minimum tax and the regular income tax.

deductions that would have been allowed had the property been depreciated using under the straight-line method over prescribed (extended) recovery periods;

- (d) the tax preference for capital gains;
- (e) the excess of amortization deductions for pollution control facilities over depreciation deductions that would otherwise have been allowable in the absence of special amortization;
- (f) in the case of mining exploration and development costs and circulation expenditures, the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs or expenditures been amortized over a ten-year period;
- (g) in the case of intangible drilling and development costs of oil, gas, and geothermal properties, the amount by which (i) the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period, exceeds (ii) the taxpayer's net income from oil, gas, and geothermal properties;
- (h) the excess of depletion deductions over the basis of the depletable property; and
- (i) in the case of stock transferred pursuant to the exercise of an incentive stock option, the excess of the fair market value over the option price.

#### Reasons For Change

The alternative and corporate minimum taxes were originally enacted as part of the Tax Reform Act of 1969 to ensure that "all taxpayers are required to pay significant amounts of tax on their economic income." The measures (originally a single minimum tax for all taxpayers) were considered necessary because, as concluded by Congress, "many individuals and corporations did not pay tax on a substantial part of their economic income as a result of the receipt of various kinds of tax-favored income or special deductions."

The judgment that a minimum tax is necessary reflects an ambivalence about the desirability and effectiveness of the tax preferences subject to the tax. For example, percentage depletion and accelerated methods of depreciation have traditionally been allowed in part to subsidize the cost of productive depreciable assets and mineral production activities. However, Congress disapproved the necessary consequence that taxpayers receiving the bulk of their income from nonpreferred activities were taxed at relatively higher rates than taxpayers engaged in activities, such as real estate or natural resource production, that benefitted from tax preferences.

The ambivalence in current law toward tax preferences reflects significant doubt about their fairness, efficiency, costs in lost revenue and consequent effect on marginal tax rates. In general, the Treasury Department proposals accept these doubts as well founded and seek to redesign the income tax base to approximate more closely economic income. If the proposals were fully implemented, the alternative minimum tax would be unnecessary.

To the extent that (1) existing tax preferences (which generally cause a taxpayer's taxable income to be less than economic income) are phased out over an extended period, or (2) taxpayers currently holding tax-favored assets are permitted to retain benefits not available for after-acquired assets, immediate repeal of the alternative minimum tax would be inappropriate.

### Proposal

The alternative minimum tax would be repealed.

### Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1990.

### Analysis

Currently, between 100,000 and 200,000 individuals, generally with large incomes, are subject to the alternative minimum tax. Because of the AMT's complexity and its interactions with numerous deductions and tax computations, many more taxpayers -- perhaps several million -- must actually compute the AMT to determine if they are subject to it. In addition to its computational complexity and burdens, the presence or potential presence of the AMT obscures the tax consequences of certain activities. Because the impact of the AMT may not be determinable until after the close of the taxable year, taxpayers are likely to act in ways that are not economically efficient, and, hence, do not allocate resources efficiently and do not maximize economic output.

**IMPOSE FLOOR ON EMPLOYEE BUSINESS EXPENSE AND OTHER  
MISCELLANEOUS DEDUCTIONS**

**General Explanation**

**Chapter 4.03**

**Current Law**

Four categories of employee business expenses may be deducted by taxpayers regardless of whether they itemize deductions. These are:

- o expenses paid by the employee and reimbursed by the employer;
- o employee expenses of travel, meals, and lodging while away from home;
- o employee transportation expenses; and
- o business expenses of employees who are outside salesmen.

Various miscellaneous itemized deductions are allowed for taxpayers who itemize deductions. These miscellaneous itemized deductions comprise all itemized deductions other than medical expenses, charitable contributions, interest, taxes, and theft and casualty losses. They include:

- o employee business expenses other than those described above, including educational expenses, union and professional dues, safety equipment, small tools, supplies, uniforms, protective clothing, professional subscriptions, and employment agency fees;
- o gambling losses not in excess of gambling winnings;
- o expenses of producing certain income, including fees for investment services, safe deposit box rentals, trustee fees, and tax return preparation and tax advice fees.

**Reasons for Change**

Allowance of the various employee business expense deductions and the miscellaneous itemized deductions complicates recordkeeping for many taxpayers. Moreover, the small amounts that are typically involved present significant administrative and enforcement problems for the Internal Revenue Service. These deductions are also a source of numerous taxpayer errors concerning what amounts and what items are properly deductible.

## Proposal

Employee business expenses (other than those reimbursed by the employer) and the miscellaneous itemized deductions would be consolidated into a single category, together with the deduction for State and local taxes (other than income taxes) which are currently required to be itemized but which are incurred in carrying on an income-producing activity. To the extent that these items, in the aggregate, exceed one percent of a taxpayer's adjusted gross income (AGI), they would be deductible by the taxpayer, whether or not he itemizes deductions. In lieu of a deduction, employer reimbursements would be excluded from the employee's income to the extent that the employee would have been entitled to a deduction without regard to the one percent floor.

## Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

## Analysis

Disallowance of a deduction for a normal level of employee business expenses and miscellaneous itemized deductions would simplify recordkeeping, reduce taxpayer errors and ease administrative burdens for the Internal Revenue Service while still providing fair treatment for taxpayers who incur an unusually high level of such expenses.

In 1982, one-half of all itemizers claimed miscellaneous deductions of less than one-half of one percent of their AGI. Fifty-eight percent claimed deductions of less than one percent of their AGI, and 93 percent claimed deductions of less than five percent of their AGI. Thus, introduction of a "floor" or "threshold" of one percent of AGI would substantially reduce the number of returns claiming this deduction. The proposed extension of the miscellaneous deduction to nonitemizers would partially offset the revenue gain from introduction of the floor.

The proposal would broaden the tax base and, thus, contribute to the reduction in marginal tax rates. Any increase in tax liability resulting from this proposal should be more than offset by the reduced marginal rates and the increase in the zero bracket amount and the personal exemption.

## REPEAL POLITICAL CONTRIBUTION CREDIT

### **General Explanation**

#### **Chapter 4.04**

#### **Current Law**

Individuals are allowed a nonrefundable tax credit for contributions to political candidates and political action committees. The credit equals one-half of the first \$100 (\$200 for joint returns) of an individual's contributions during the year.

#### **Reasons For Change**

The tax credit for political campaign contributions is not related to the proper measurement of income, but rather is intended to encourage individuals to contribute to the cost of the political process. The actual effect of the political contribution credit in producing additional political contributions is open to question. The credit produces no marginal incentive for taxpayers who without regard to the credit would make contributions of \$100 or more. The credit also creates no incentive for low-income individuals who have no income tax liability.

The political contribution credit presents administrative and compliance problems for the Internal Revenue Service. The subject matter of the credit may involve the Internal Revenue Service in sensitive inquiries about political affiliation. Moreover, the small dollar amounts involved on each tax return make verification difficult and expensive relative to the amounts involved. There are some indications that increasing numbers of taxpayers may be claiming credits for which no contributions have been made.

Finally, the political contribution credit creates complexity for taxpayers. It adds a line to income tax forms, and, for honest taxpayers, entails an additional recordkeeping burden.

#### **Proposal**

The credit for political contributions would be repealed.

#### **Effective Date**

The repeal would be effective for taxable years beginning on or after January 1, 1986.

#### **Analysis**

In 1982, the political contribution credit was claimed on about 5.2 million returns, or about 6.6 percent of all individual returns with some tax liability before deducting tax credits.



As shown in Table 1, the number of users of the credit is skewed heavily toward higher-income taxpayers. Only 2.8 percent of all returns with income of \$10,000 or less (and with some tax liability) used the credit whereas 38.4 percent of all returns with income of \$100,000 or more claimed the credit. However, because the credit is limited to \$50 (\$100 on joint returns), tax benefits slightly favor those in lower-income brackets. In 1982, the Federal revenue loss from the credit was \$270 million. The percentage distribution of those benefits is shown in the Table 1.

Table 1  
Use of the Political Contributions Tax Credit - 1982

AGI Class	Percentage of Returns Claiming Credit 1/	Distribution of Tax Benefit from Credit (percentages)	Distribution of Tax Liability (percentages)
\$ 0 to 9,999	2.8	8.2	2.5
10,000 to 19,999	4.5	17.1	12.5
20,000 to 29,999	6.5	20.9	18.8
30,000 to 49,999	10.0	29.4	30.8
50,000 to 99,999	20.8	16.6	18.2
100,000 and over	38.4	7.8	17.2
All Returns	6.6	100.0	100.0

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1/ Percentage of all returns with some tax liability before tax credits.

Even if a large portion of the tax reduction attributable to the credit is not simply a windfall benefit to taxpayers who would have made a contribution anyway, the total subsidy from the credit represents only a relatively small portion of total political campaign expenditures in the United States.

Repeal of the credit would not cause a significant increase in tax liability for any group of taxpayers.

## REPEAL PRESIDENTIAL CAMPAIGN CHECK-OFF

### General Explanation

#### Chapter 4.05

#### Current Law

The Presidential election campaign check-off permits each individual who has income tax liability to elect to have one dollar of that liability used to finance Presidential election campaigns. By statute, the check-off information must be either on the first page of the income tax return or on the page that bears the taxpayer's signature.

#### Reasons For Change

The Presidential election campaign check-off is unrelated to the purposes of the income tax and is a source of complexity for taxpayers. The check-off does not directly affect individual tax liabilities, but simply allows taxpayers to direct that a small portion of their taxes be spent in a particular way. The use of the tax return system for this purpose is unique to the campaign check-off. For the many taxpayers who do not understand its purpose or effect, the check-off is a source of confusion. In addition, the check-off complicates tax forms, significantly in the case of the shorter forms, such as the 1040EZ.

#### Proposal

The Presidential election campaign check-off would be repealed.

#### Effective Date

The repeal would be effective for tax liability in taxable years beginning on or after January 1, 1986.

#### Analysis

Approximately one-fourth of all taxpayers (one-third of those taxpayers with some income tax liability) use this provision to earmark funds for Presidential campaigns. The percentage of taxpayers using the provision varies somewhat between election and nonelection years.

Since use of the campaign check-off does not increase any individual's income tax liability, taxpayers would not be adversely affected by repeal of this provision. Repeal of the check-off would eliminate public funds for Presidential campaigns unless direct appropriations were provided.

## **REPEAL ADOPTION EXPENSE DEDUCTION**

### **General Explanation**

#### **Chapter 4.06**

##### **Current Law**

Current law permits a deduction for "qualified adoption expenses" paid or incurred during the taxable year. In general, qualified adoption expenses include the reasonable and necessary adoption fees, court costs, attorney's fees, and other expenses directly related to the legal adoption of a "child with special needs" as defined in the Social Security Act.

The maximum amount of qualified adoption expenses that may be deducted with respect to a child is \$1,500. Moreover, no expense may be deducted as a qualified adoption expense if a credit or deduction is otherwise allowable for such expense or if such expense is paid for by a grant from a Federal, State or local program.

##### **Reasons for Change**

The allowance of a deduction for certain adoption expenses is an inappropriate way of providing Federal support for those who adopt children with special needs. Federal programs supporting such children or the families who adopt them should be under the supervision and control of agencies familiar with their needs. Such agencies should also have budgetary responsibility for costs of programs serving these purposes. Providing Federal support through the tax system is inconsistent with each of these objectives.

##### **Proposal**

The deduction for qualified adoption expenses would be repealed and replaced by a direct expenditure program.

##### **Effective Date**

The proposal would generally be effective for taxable years beginning on or after January 1, 1987 and would generally apply to expenses paid or incurred after such date. Taxpayers having incurred qualified adoption expenses with respect to a child prior to the date the proposal is introduced in legislation would be entitled to deduct qualified adoption expenses incurred after the effective date with respect to such child.

##### **Analysis**

It is anticipated that a direct expenditure program would be enacted to continue Federal support for families adopting children with special needs. The effective date of such program should be coordinated with the proposed repeal of the current deduction.